

Office of the State Auditor

Division of State Audit

Securities Department Bismarck, North Dakota

Audit Report for the
Two-Year Period Ended June 30, 2006
Client Code 414

Robert R. Peterson
State Auditor



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Transmittal Letter

June 11, 2007

The Honorable John Hoeven, Governor
Members of the North Dakota Legislative Assembly
Karen Tyler, Commissioner

We are pleased to submit this audit of the North Dakota Securities Department for the two-year period ended June 30, 2006. This audit resulted from the statutory responsibility of the State Auditor to audit or review each state agency once every two years. The same statute gives the State Auditor the responsibility to determine the contents of these audits.

In determining the contents of the audits of state agencies, the primary consideration was to determine how we could best serve the citizens of the state of North Dakota. Naturally we determined financial accountability should play an important part of these audits. Additionally, operational accountability is addressed whenever possible to increase efficiency and effectiveness of state government.

The in-charge auditor for this audit was Andrea Wike. Angela Klubberud was the staff auditor. Cindi Pedersen, CPA was the audit supervisor and Paul Welk, CPA was the audit manager. Inquiries or comments relating to this audit may be directed to the audit manager by calling (701) 328-2320. We wish to express our appreciation to Commissioner Tyler and her staff for the courtesy, cooperation, and assistance they provided to us during this audit.

Respectfully submitted,

Robert R. Peterson
State Auditor

Executive Summary

INTRODUCTION

The North Dakota Securities Department was created as a result of the Securities Act of 1951 with statutory authority under Chapter 10-04, Chapter 43-10.1, Chapter 51-19, and Chapter 51-23 of the North Dakota Century Code. The function of the North Dakota Securities Department is to protect the public and private sector in matters involving the issuance and sale of securities, sale of franchises, sale or execution of pre-need funeral service contracts, and registration of salesmen, brokers or dealers handling the sale of securities. The Securities Department also issues cease and desist orders to individuals and corporations attempting to sell securities without approval; provides exemptions for companies who meet the stated requirements; and investigates and prosecutes violators of the state's securities laws. In an effort to achieve uniformity in securities legislation, the Securities Department cooperates with the administrators of federal and state securities laws.

RESPONSES TO LAFRC AUDIT QUESTIONS

The Legislative Audit and Fiscal Review Committee (LAFRC) requests that certain items be addressed by auditors performing audits of state agencies.

1. What type of opinion was issued on the financial statements?

Financial statements were not prepared by the North Dakota Securities Department in accordance with generally accepted accounting standards so an opinion is not applicable. The agency's transactions were tested and included in the state's basic financial statements on which an unqualified opinion was issued.

2. Was there compliance with statutes, laws, rules, and regulations under which the agency was created and is functioning?

Other than our finding addressing "noncompliance with the collection of franchise fees" (see page 15), the North Dakota Securities Department was in compliance with significant statutes, laws, rules, and regulations under which it was created and is functioning.

3. Was internal control adequate and functioning effectively?

Yes.

4. Were there any indications of lack of efficiency in financial operations and management of the agency?

No.

5. *Has action been taken on findings and recommendations included in prior audit reports?*

The North Dakota Securities Department has implemented all recommendations included in the prior audit report.

6. *Was a management letter issued? If so, provide a summary below, including any recommendations and the management responses.*

Yes, a management letter was issued and is included on pages 17-18 of this report, along with management's response.

LAFRC AUDIT COMMUNICATIONS

1. *Identify any significant changes in accounting policies, any management conflicts of interest, any contingent liabilities, or any significant unusual transactions.*

There were no significant changes in accounting policies, no management conflicts of interest were noted, no contingent liabilities were identified or significant unusual transactions.

2. *Identify any significant accounting estimates, the process used by management to formulate the accounting estimates, and the basis for the auditor's conclusions regarding the reasonableness of those estimates.*

The North Dakota Securities Department's financial statements do not include any significant accounting estimates.

3. *Identify any significant audit adjustments.*

Significant audit adjustments were not necessary.

4. *Identify any disagreements with management, whether or not resolved to the auditor's satisfaction relating to a financial accounting, reporting, or auditing matter that could be significant to the financial statements.*

None.

5. *Identify any serious difficulties encountered in performing the audit.*

None.

6. *Identify any major issues discussed with management prior to retention.*

This is not applicable for audits conducted by the Office of the State Auditor.

7. *Identify any management consultations with other accountants about auditing and accounting matters.*

None.

8. *Identify any high-risk information technology systems critical to operations based on the auditor's overall assessment of the importance of the system to the agency and its mission, or whether any exceptions identified in the six audit report questions to be addressed by the auditors are directly related to the operations of an information technology system.*

ConnectND Finance, Human Resource Management System (HRMS), and the Securities Program are high-risk information technology systems critical to the North Dakota Securities Department.

Background Information

The mission of the North Dakota Securities Department is to regulate the offer and sale of securities and franchises in the state of North Dakota, and to protect the investing public by enforcing compliance with our state's laws. The North Dakota Securities Department promotes public awareness of securities laws to prevent violations and to prevent investment fraud. The North Dakota Securities Department provides investor education programs for all ages to improve the level of financial literacy in our state. The North Dakota Securities Department is an agency headed by Karen Tyler, Securities Commissioner, who is appointed by the Governor.

Responsibilities of the North Dakota Securities Department include: enforcement of the North Dakota Securities Act, North Dakota Franchise Investment Law, law relating to Pre-Need Funeral Services, and law relating to Commodities Transactions; registration of securities offerings, broker-dealer and investment adviser firms and their representatives, and franchises; investigation of consumer complaints and initiation of appropriate disciplinary action; and promotion of sound financial planning through investor education programs.

All persons who propose to act as brokers, dealers, and agents for the sale of securities in North Dakota must be registered with the North Dakota Securities Department prior to engaging in such activities.

The main office is located in Bismarck; however, in December 2005, the North Dakota Securities Department established an office in Fargo. The primary function of the Fargo office is the execution of routine compliance exams of firms located in eastern North Dakota and to assist North Dakota investors seeking to file a complaint with the department.

The North Dakota Securities Department's budget for the 2005-2007 biennium totals \$1.7 million. This represents a 20% increase over the 2003-2005 budget. The state general funds comprise \$1.46 million of the 2005-2007 budget.

More information about the agency can be obtained from the North Dakota Securities Department's home page at:

www.ndsecurities.com

Audit Objectives, Scope, And Methodology

Audit Objectives

The objectives of this audit of the North Dakota Securities Department for the two-year period ended June 30, 2006 were to provide reliable, audited financial statements and to answer the following questions:

1. What are the most important areas of the North Dakota Securities Department's operations and is internal control adequate in these areas?
2. What are the significant and high-risk areas of legislative intent applicable to the North Dakota Securities Department and are they in compliance with these laws?
3. Are the areas of the North Dakota Securities Department's operations where we can help to improve efficiency or effectiveness?

Audit Scope

This audit of the North Dakota Securities Department for the two-year period ended June 30, 2006 was conducted in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States. To meet the objectives outlined above, we:

Audit Methodology

- Prepared financial statements from the legal balances on the state's accounting system tested as part of this audit and the audit of the state's Comprehensive Annual Financial Report and reviewed management's discussion and analysis of the financial statements.
- Performed detailed analytical procedures for expenditures and receipts.
- Tested samples of expenditures, journal vouchers, and correcting entries.
- Reviewed prior year audit workpapers.
- Interviewed appropriate agency personnel.
- Reviewed North Dakota Securities Department written plans and applicable manuals.
- Observed North Dakota Securities Department's processes and procedures.
- Reviewed North Dakota Century Code chapters 10-04, 43-10.1, 51-19, and 51-23 and the 2003 and 2005 Session Laws.
- Searched for recent studies or reports relating to the North Dakota Securities Department.

Management's Discussion And Analysis

The accompanying financial statements have been prepared to present the North Dakota Security Department's revenues and expenditures on the legal (budget) basis. The accompanying financial statements are not intended to be presented in accordance with generally accepted accounting principles (GAAP).

The following management discussion and analysis was prepared by the North Dakota Security Department's management. We have applied certain limited procedures, which consisted primarily of inquiries of management regarding the methods of measurement and presentation of this supplementary information to ensure it does not conflict with the knowledge we gained as part of our audit.

For the two-year period June 30, 2006, operations of the North Dakota Securities Department were primarily supported by appropriations from the state's general fund.

FINANCIAL SUMMARY

Revenues consisted primarily of registration of securities offerings, broker-dealer and investment adviser firms and representatives. Other revenues during the audited period included various fines, the registration of franchises, miscellaneous revenue, and investor restitution funds. There were some revenue increases for the North Dakota Securities Department. There was an increase of \$486,217 in licenses, permits, and fees. The financial services industry experienced a healthy rate of growth during the audit period and this had an impact on the North Dakota Securities Department revenue, as the broker dealer and investment advisor sectors expanded and hired new employees. The majority of the increased revenue in this area is due to an increase in the number of registered broker dealer agents and investment adviser representatives and securities offering filings. There was also an increase of \$95,458 in Fines and Forfeitures. This increase can be attributed to a general upward trend in number of enforcement actions taken by the North Dakota Securities Department. This upward trend is expected to continue as the number of investors entering the capital markets continues to rise and as the North Dakota Securities Department effectively deploys enhanced enforcement resources. Total revenues were \$7,680,870 for the year ended June 30, 2006 as compared to \$7,099,907 for the year ended June 30, 2005.

Total expenditures for the North Dakota Securities Department were \$777,033 for the year ended June 30, 2006 as compared to \$722,189 for the prior year. There was an increase in salaries in the amount of \$53,672 from fiscal year 2005 to fiscal year 2006. During the 2005 legislative session, authorization was given to add an investigator/examiner in a new office to be established in the eastern region of the state. This employee was hired in December of 2005. The decrease of \$68,461 in operating fees and services was primarily due to the decrease in restitution payment passing through the North Dakota Securities Department's Investor Restitution fund, and a decrease in expenses related to the development of investor education materials.

AGENCY ACTIVITIES

The prevention of fraud and misconduct is a critical component of the Department's investor protection mandate. Routine exams are a preventative mechanism. Routine exams of broker dealer and investment advisor firms serve as an early warning system, and can uncover regulatory compliance deficiencies and deter securities agent misconduct before the North Dakota investor is harmed.

During the 2005 legislative session, the North Dakota Securities Department sought and obtained funding for an additional examiner, and to establish an office in the eastern region of the state to facilitate a planned increase in the number of routine exams to be conducted by the North Dakota Securities Department. Given the distribution and location of broker dealer and investment advisor firms and professionals in the state, the positioning of an examiner in the eastern region was a strategically sound approach.

The primary objective of the North Dakota Securities Department's enforcement mandate is the return of money to harmed investors. Investigations of fraud and misconduct and subsequent enforcement actions result in monies returned to North Dakota investors through rescission, recovery, and restitution. Enforcement actions protect the integrity of our capital markets and investor confidence therein. In some cases, enforcement actions generate revenue as a result of the assessment of civil penalties against wrongdoers.

The North Dakota Securities Department's enforcement caseload is tracking higher than the previous biennium. The sale of securities by unregistered individuals, ponzi schemes, and unsuitable variable annuity sales represent the type of cases the Department has been dealing with most frequently. The Department continues to aggressively pursue perpetrators of securities fraud and misconduct that target senior victims. "Free

lunch” sales seminars and the misuse of Senior Specialist designations are pervasive problems and are of particular concern and focus for the Department.

The delivery of financial education to our citizens of all ages continues to be a priority objective of the North Dakota Securities Department. We view financial education as a preventative mechanism critical to our Investor Protection mandate and we view it as the first and best defense against investment fraud. Financial education helps our citizens build the knowledge they need to make good personal financial decisions, and the North Dakota Securities Department maintains the position that there is a direct correlation between the financial decision-making aptitude of our citizens and the economic health of our families, our communities, and the state overall.

The hallmark of our various education programs is the Invest North Dakota Teacher Training Academy held every summer at the University of Mary. The Academy, which was held for the 9th and 10th year during the audit period, provides our teachers with the training and resources they need to integrate financial education into the classroom curriculum. Over 1300 North Dakota teachers have participated in this event since its inception and we estimate that per biennium, approximately 90,000 North Dakota students benefit from the various financial education programs delivered by the agency.

Financial Statements

STATEMENT OF REVENUES AND EXPENDITURES

	June 30, 2006	June 30, 2005
<u>Revenues and Other Sources:</u>		
Licenses, Permits, and Fees	\$7,301,827	\$6,815,610
Fines and Forfeitures	373,394	277,936
Other Revenues	5,649	6,360
Total Revenues and Other Sources	\$7,680,870	\$7,099,906
<u>Expenditures and Other Uses:</u>		
Salaries and Benefits	\$516,762	\$463,090
Supply/Material-Professional	68,555	67,541
Travel	32,186	19,818
Professional Development	29,543	22,007
Operating Fees and Services	27,336	95,797
IT Equipment under \$5,000	21,970	
Fees - Professional Services	13,238	4,011
Printing	12,231	4,571
IT - Data Processing	12,075	9,297
IT - Communications	9,416	7,868
Office Supplies	6,356	5,765
Rentals/Leases - Building/Land	4,837	300
Postage	4,727	5,022
Office Equipment and Furniture – Under \$5,000	4,512	6,586
Rentals/Leases-Equipment and Other	4,299	2,795
IT Contractual Services and Repairs	3,055	5,068
Repairs	2,865	69
Supplies - IT Software	2,067	1,583
Other Operating Expenses	1,003	1,010
Total Expenditures and Other Uses	\$777,033	\$722,198

STATEMENT OF APPROPRIATIONS

For Fiscal Year Ended June 30, 2006

Expenditures by Line Item:	<u>Original Appropriation</u>	<u>Adjustments</u>	<u>Final Appropriation</u>	<u>Expenditures</u>	<u>Unexpended Appropriation</u>
Salaries and Wages	\$ 1,105,588		\$ 1,105,588	\$ 513,993	\$ 591,655
Operating Expenses	570,855		570,855	263,100	307,755
Totals	<u>\$ 1,676,443</u>	<u>\$ 0</u>	<u>\$ 1,676,443</u>	<u>\$ 777,033</u>	<u>\$ 899,410</u>
Expenditures by Source:					
General Fund	\$ 1,459,244		\$ 1,459,244	\$ 674,400	\$ 784,844
Other Funds	217,199		217,199	102,633	114,566
Totals	<u>\$ 1,676,443</u>	<u>\$ 0</u>	<u>\$ 1,676,443</u>	<u>\$ 777,033</u>	<u>\$ 899,410</u>

Expenditures Without Appropriations Of Specific Amounts:

Investor Restitution Fund has a continuing appropriation authorized by NDCC section 10-04-03(5). There were no expenditures this biennium.

STATEMENT OF APPROPRIATIONS

For Biennium Ended June 30, 2005

Expenditures by Line Item:	<u>Original Appropriation</u>	<u>Adjustments</u>	<u>Final Appropriation</u>	<u>Expenditures</u>	<u>Unexpended Appropriation</u>
Salaries and Wages	\$ 925,523	\$ 566	\$ 926,089	\$ 924,630	\$ 1,460
Operating Expenses	466,222	(566)	465,656	399,739	65,917
Totals	<u>\$ 1,391,745</u>	<u>\$ 0</u>	<u>\$ 1,391,745</u>	<u>\$ 1,324,369</u>	<u>\$ 67,367</u>
Expenditures by Source:					
General Fund	\$ 1,080,165		\$ 1,080,165	\$ 1,071,181	\$ 8,984
Other Funds	311,580		311,580	253,188	58,393
Totals	<u>\$ 1,391,745</u>	<u>\$ 0</u>	<u>\$ 1,391,745</u>	<u>\$ 1,324,369</u>	<u>\$ 67,367</u>

Appropriation Adjustments:

The change in appropriation was due to an Emergency Commission request on May 23, 2005 to move \$566 from the operating line into the salaries and wages line for a health insurance premium increase effective July 1, 2005, which was applied to the June 2005 payroll.

Expenditures Without Appropriations Of Specific Amounts:

Investor Restitution Fund has a continuing appropriation authorized by NDCC section 10-04-03(5) (\$82,600 of expenditures for this biennium).

Internal Control

In our audit for the two-year period ended June 30, 2006, we identified the following areas of the North Dakota Securities Department's internal control as being the most important:

Internal Controls Subjected To Testing

- Controls surrounding the processing of revenues.
- Controls surrounding the processing of expenditures.
- Controls relating to compliance with legislative intent.
- Controls surrounding the ConnectND (PeopleSoft) system.
- Controls surrounding the computer-based Securities Program.

We gained an understanding of internal control surrounding these areas and concluded as to the adequacy of their design. We also tested the operating effectiveness of those controls we considered significant. We concluded internal control was adequate. Our consideration of internal control would not necessarily disclose all matters that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements that would be material may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving internal control and its operation that we consider to be material weaknesses. However, we noted other matters involving internal control that we have reported to management of the North Dakota Securities Department in a management letter dated June 11, 2007.

Compliance With Legislative Intent

In our audit for the two-year period ended June 30, 2006, we identified and tested North Dakota Securities Department's compliance with legislative intent for the following areas that we determined to be significant and of higher risk of noncompliance:

Legislative Intent Subjected To Testing

- Application of proper statutory rates relating to revenue.
- Proper registration and collection of fees required for the sale of securities and renewal applications.
- Proper rates charged for the licensing of those selling securities.
- Proper reports and surety bonds were filed for pre-need funeral services.
- Proper regulation of and proper fees charged for the sale of franchises.
- Proper use of the Investor Restitution Fund for repaying defrauded investors and the Investor Education and Technology Fund mainly used for investor education and technology equipment.
- Proper use of the State Treasurer (State Constitution, article X, section 12).
- Compliance with appropriations and related transfers (2003 North Dakota Session Laws chapter 32 and 2005 North Dakota Session Laws chapter 11).
- Compliance with OMB's Purchasing Procedures Manual.
- Travel-related expenditures are made in accordance with OMB policy and state statute.
- Adequate blanket bond coverage of employees (NDCC section 26.1-21-08).
- Compliance with fixed asset requirements including record keeping, surplus property, lease and financing arrangements in budget requests, and lease analysis requirements.
- Compliance with payroll related laws including statutory salaries for applicable elected and appointed positions, and certification of payroll.

The results of our tests disclosed an instance of noncompliance that is required to be reported under *Government Auditing Standards*. This finding is described below. Other than this finding, we concluded there was compliance with the legislative intent identified above. We also noted certain immaterial instances of noncompliance that we have reported to management of the North Dakota Securities Department in a management letter dated June 11, 2007.

NONCOMPLIANCE WITH COLLECTION OF FRANCHISE FEES

Finding 06-1

The North Dakota Securities Department did not consistently collect fees for franchise applications and amendments to applications in accordance with North Dakota Century Code (NDCC) 51-19-17 (2c) and (2d).

The agency is to collect a \$100 fee for filing an application for renewal and a \$50 fee for filing an amendment to the application. Based on how the franchisee interpreted the law, some would send in \$100 for a renewal of an application with an amendment and others would send in \$150. The agency deposited any amount that was given to them.

NDCC 51-19-17 (2c) states: "The fee for filing an application for renewal of an application is one hundred dollars." NDCC 51-19-17 (2d) states: "The fee for filing an amendment to the application is fifty dollars."

Audit Recommendation
and Agency Response

Recommendation:

We recommend that the North Dakota Securities Department consistently collect fees in accordance with NDCC 51-19-17 Sections (2c) and (2d).

North Dakota Securities Department Response:

I agree with the formal recommendation set forth in the Auditor's Report pertaining to the audit of the North Dakota Securities Department for the two-year period ended June 30, 2006.

Operations

This audit did not identify areas of the North Dakota Securities Department's operations where we determined it was practical at this time to help to improve efficiency or effectiveness.

Management Letter (Informal Recommendations)

June 11, 2007

Karen Tyler
Commissioner
North Dakota Securities Department
State Capitol
600 E Boulevard Avenue
Bismarck, North Dakota 58505

Dear Karen Tyler:

We have performed an audit of the North Dakota Securities Department for the two-year period ended June 30, 2006, and have issued a report thereon. As part of our audit, we gained an understanding of the North Dakota Securities Department's internal control structure to the extent we considered necessary to achieve our audit objectives. We also performed tests of compliance as described in the same report.

Our audit procedures are designed primarily to enable us to report on our objectives including those related to internal control and compliance with laws and regulations and may not bring to light all weaknesses in systems and procedures or noncompliance with laws and regulations which may exist. We aim, however, to use our knowledge of your organization gained during our work to make comments and suggestions which we hope will be useful to you.

In connection with the audit, gaining an understanding of the internal control structure, and tests of compliance with laws and regulations referred to above, we noted certain conditions we did not consider reportable within the context of your audit report. These conditions relate to areas of general business practice or control issues that have no significant bearing on the administration of federal funds. We do, however, want to present our recommendations to you for your consideration and whatever follow-up action you consider appropriate. During the next audit we will determine if these recommendations have been implemented, and if not, we will reconsider their status as non-reportable conditions.

The following present our informal recommendations.

LEGISLATIVE INTENT

Informal Recommendation 06-1: We recommend the ND Securities Department follow OMB policy 214 regarding the crediting of appropriations.

Informal Recommendation 06-2: We recommend the ND Securities Department conduct an annual physical inventory in accordance with NDCC 44-04-07.

Informal Recommendation 06-3: We recommend the ND Securities Department reconcile the agency-wide purchase card statement to the individual statements.

Informal Recommendation 06-4: We recommend the ND Securities Department follow the purchasing procedures outlined by OMB in the Purchasing Procedures Manual.

Informal Recommendation 06-5: We recommend the ND Securities Department use the proper Peoplesoft account for travel expenditures.

Informal Recommendation 06-6: We recommend the ND Securities Department maintain proper documentation for travel expenses.

GENERAL

Informal Recommendation 06-7: We recommend the North Dakota Securities Department maintain proper internal controls by having an independent reconciliation of money deposited to receipts.

Informal Recommendation 06-8: We recommend the ND Securities Department maintain proper documentation for general ledger transactions. We also recommend the individual responsible for approval adequately review general ledger transactions to ensure proper coding.

Management of North Dakota Securities Department agreed with these recommendations.

I encourage you to call myself or an audit manager at 328-2320 if you have any questions about the implementation of recommendations included in your audit report or this letter.

Sincerely,

Andrea Wike
Auditor in-charge